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entered June 29, 1945 (R. 146). The petition for a writ of certiorari was filed on September 25, 1945. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

In 1934 the taxpayer accepted a deed to real estate in full satisfaction of the mortgage loan on certain property and charges for taxes and other items which were secured by the trust deed. There was no appraisal of the property at that time, the property was valued on the taxpayer's books in an amount equal to the debt, and the taxpayer's deduction for a reasonable addition to its reserve for bad debts under Section 23 (k) of the Revenue Act of 1934 was made without any reference to this transaction.

The question is whether the addition to the reserve fund allowed as a deduction in 1934 may be increased by the loss disclosed as a result of an appraisal made in 1938.

STATUTE AND REGULATIONS INVOLVED

The pertinent statute and regulations involved are set forth in the Appendix, *infra*, pp. 18–21.

STATEMENT

The pertinent facts may be summarized as follows:

On or about September 2, 1932, the taxpayer loaned $180,000 to the Hollywood Improvement Company, a corporation, then doing business in Los Angeles, California. The Hollywood Improvement Company concurrently therewith executed and delivered to the taxpayer its promissory note payable to the order of the taxpayer in the principal amount of $180,000, and executed and delivered to the taxpayer a deed of trust securing the promissory note covering certain real estate located at the southwest corner of Eleventh and Hill Streets, in Los Angeles, California. The promissory note provided, among other things, that the Hollywood Improvement Company should not be personally liable upon the promissory note or for any deficiency following sale under or foreclosure of the deed of trust. (R. 2–3, 40, par. 1.)

During 1933 the Hollywood Improvement Company failed to pay interest as provided in the promissory note and failed to pay taxes upon the property as provided in the deed of trust. Each of the defaults thereafter continued and no payment of any of the sums was made by that Company. The deed of trust provided that failure to make any of the payments should constitute a default; that thereupon the taxpayer should have the right to demand that the property be sold; and that the proceeds of such sale, after payment of expenses specified in the deed of

trust, be applied to the payment of the promissory note. (R. 3, 40, par. 1.)

Subsequent to September 2, 1932, and prior to May 15, 1934, the taxpayer paid the state and county taxes, assessments, charges for policy of title insurance, and charges for repairs upon the property, and other items, in the amount of $8,416.68, all of which, under the terms of the trust deed, the Hollywood Improvement Company had agreed were secured by the trust deed. On or about May 15, 1934, the total amount of principal and interest secured by the trust deed was $186,930 which, together with the $8,416.68 secured by the trust deed, made a total of $195,346.68. No part of the latter amount had been paid except $832.74, and on or about May 15, 1934, the difference between those amounts, $194,513.94, remained due and unpaid. (R. 3–4, 40, par. 1.)

On or about May 15, 1934, the taxpayer accepted from the Hollywood Improvement Company, in satisfaction of the indebtedness of $194,513.94, a grant deed covering the property described in the deed of trust given as security for the indebtedness. The grant deed was accepted by the taxpayer in lieu of causing a sale to be made by the trustee named in the deed of trust pursuant to the terms thereof. In order to induce the Hollywood Improvement Company to transfer title of the property described in the deed of trust to the taxpayer in satisfaction of the in-

debtedness the taxpayer, in lieu of paying the expense of a trust deed sale which it estimated at $1,600, paid to the Hollywood Improvement Company $800.[1] (R. 4, 40, par. 1.)

On or about May 15, 1934, the fair market value of the real property described in the deed of trust, including improvements, was $70,000. The improvements upon the property consisted of a building which on May 15, 1934, had a fair market value of $7,854.[2] (R. 4–5, 40, par. 1.)

The taxpayer accordingly suffered a loss of $124,513.94 on this transaction. (R. 40.)

At all times herein and since the year 1921, the taxpayer's principal business has been the purchase of contracts for the conditional sale of automobiles and the collection and receipt of payments falling due under the contracts, and no substantial part of the taxpayer's business has consisted of making loans on the security of real estate. (R. 40.) The loss of $124,513.94 occurred outside the usual and ordinary course of the taxpayer's business. (R. 41.)

At all times herein the taxpayer followed the practice of deducting from income on its income tax returns additions made to a reserve for bad

[1] The facts in this paragraph, as found by the District Court (R. 40, par. 1), were stipulated between the parties (R. 105–106, par. 2).

[2] The facts in this paragraph, as found by the District Court (R. 40, par. 1), were also stipulated between the parties (R. 105, par. 1).

debts and did not follow the practice of deducting on its income tax returns debts ascertained to be worthless. For the years 1932–1935, the taxpayer determined the amount to be added to its reserve for bad debts by surveying and analyzing its accounts receivable and estimating as accurately as possible the probable eventual loss that it would incur by reason of its inability to collect such accounts receivable in full. The taxpayer's practice for each of those years was to make such addition to its reserve for bad debts as would increase the reserve to the total amount of the loss estimated in the manner above set forth. In making such calculation it was also the taxpayer's practice to take into consideration bad debt losses actually incurred during the year. (R. 40–41.)

The taxpayer, in its federal income tax return for each of those years, deducted from gross income the total additions made by it during each year to its reserve for bad debts in the manner above stated. For the year 1934 the taxpayer made on its books and deducted from gross income on its federal income tax return additions to its reserve for bad debts in the aggregate amount of $49,595.44. In determining the amount of the additions to its bad debt reserve aggregating $49,595.44 for the year 1934, the taxpayer did not take into consideration and did not make any allowance for the loss of $124,-

513.94. (R. 41.) The taxpayer has not at any time before or since the year 1934 on its books or in its income tax returns made any addition to the reserve on account of this loss. (R. 41–42.)

At all times mentioned herein the taxpayer filed its federal income tax returns on a calendar year basis. Its return for the year 1934 reported a net income of $219,751.24 on which it computed and paid a tax of $30,215.80 during 1935. Thereafter, an additional federal income tax for the year 1934 was assessed against the taxpayer in the amount of $696.61 which, together with interest in the sum of $45.96, it paid on April 21, 1936, to the Collector of Internal Revenue for the Sixth District of California, appellant below. (R. 6–7, 42, par. 3.)

Prior to March 15, 1938, that is, on or about March 11, 1938, the taxpayer executed and filed with the Collector a claim for refund of federal income tax for the year 1934. (R. 7.) It was stated in the claim for refund, in part, as follows (R. 12):

> The officers of the Company have recently been making inquiries as to the curent market price of the property with a view to disposing of it. These inquiries indicate that if it is desired to dispose of the property at the present time (1938) considerable loss will have to be sustained. Since the general real estate market in Los

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> Angeles is apparently at as high a level in 1938 as it was in 1934, it is possible that in the event of a sale of the property the Commissioner of Internal Revenue may determine that the fair market value of the property when acquired in 1934 was not as great as $188,383.94.
>
> This claim is being filed to protect the taxpayer's rights to an additional deduction for a bad debt loss in 1934 in the event the Commissioner determines that the fair market value at date of acquisition of the property was less than $188,383.94. For purpose of determining the overassessment asserted in this claim, a valuation of $125,000.00 has been assumed, being approximately twice the assessed value as of the first Monday in March 1934.

Thereafter, on July 18, 1940, the Commissioner of Internal Revenue rejected the claim for refund, notice being mailed to the taxpayer on or after July 18, 1940.[3] (R. 7, 42, par. 3.)

The District Court found that the taxpayer did not make any allowance for the loss of $124,513.94 in determining its addition to its reserve fund in 1934 for the reason that it had construed

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[3] The District Court found the statements in the two preceding paragraphs, taken from the taxpayer's amended complaint (R. 6–7, pars. 10–11), to be true (R. 42).

the transaction as a purchase of the property for $194,513.94.[4] (R. 41.)

The District Court allowed an increase in the addition to the reserve fund in 1934 and entered judgment for the taxpayer (R. 45–48); upon the Government's appeal (R. 49), the Circuit Court of Appeals reversed (R. 131–144).

ARGUMENT

The court below correctly held that since no appraisal of the property was made until 1938 and no action was taken in 1934 to ascertain whether the value of the property was less than the debt, and no part of the debt was therefore ascertained to be unrecoverable in that year, no increase in the 1934 addition to the reserve for bad debts should be made on account of the dif-

[4] The District Court further found that at the end of the year 1934, the taxpayer knew that the indebtedness theretofore owed it by the Hollywood Improvement Company no longer existed, and that the amount by which the total of the indebtedness exceeded the market value of the Eleventh and Hill streets property on or about May 15, 1934, could not be collected or recovered from the Hollywood Improvement Company. (R. 43.) The Circuit Court of Appeals determined that there was no evidence to sustain that finding (R. 134–135), and no error has been assigned as to this.

Other facts found by the District Court (R. 42, par. 4; R. 43, par. 5 (embracing the material set forth in pars. (a) to (g), inclusive, at R. 29–35); R. 43, pars. 6–7; and R. 43, par. 9 (embracing the material included in pars. II–IV at R. 27–28)) have been omitted for the reason that they relate to an affirmative defense asserted by the Collector which is not here involved.

ference between the value of the property and the amount of the debt.

Under Section 23 (k) of the Revenue Act of 1934 a deduction is allowable for debts ascertained to be worthless and charged off within the taxable year, or in the discretion of the Commissioner for a "reasonable addition" to a reserve for bad debts. The statute further provides that when satisfied that a debt is recoverable only in part the Commissioner may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction. Under regulations long in effect taxpayer may treat bad debts in one of two ways: (1) He may deduct specific debts ascertained to be worthless and charged off within the taxable year, or (2) he may maintain a reserve for bad debts and deduct each year a "reasonable addition to a reserve". Whatever method is elected must be adhered to in subsequent years (a taxpayer which was in business as early as 1921 being bound by the election made in that return) unless permission to change is secured from the Commissioner. See Article 23 (k)–1 of Treasury Regulations 86.[5]

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[5] The reserve method of handling bad debts was first permitted by Section 214 (a)- (7) of the Revenue Act of 1921, c. 136, 42 Stat. 227. Currently therewith I. T. 1341, I–1 Cum. Bull. 160 (1922), was promulgated which provided in part as follows (pp. 160–161):

"In case a taxpayer computes the net addition to a reserve for bad debts for a taxable year, and it subsequently appears that the net addition was insufficient, the taxpayer cannot de-

It is clear under the regulations and well settled by decisions that either one method or the other must be consistently followed. Where the reserve method is used, only a reasonable addition to the reserve fund can be deducted, no additional deduction being allowed for a specific bad debt. *Athol Mfg. Co.* v. *Commissioner,* 54 F. 2d 230 (C. C. A. 1st); *Atlantic Bank & Trust Co.* v. *Commissioner,* 59 F. 2d 363 (C. C. A. 4th); *First Nat. Bank of Omaha* v. *Commissioner,* 49 F.

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duct in the subsequent year the amount by which the net addition to the reserve for the previous year was insufficient. * * *

"* * * In other words, the entire reserve for bad debts at all times should be, to a certain extent, based upon the total amount of debts outstanding, and, in determining what constitutes a reasonable addition for any year to such a reserve, the total amount of debts outstanding and the amount of the existing reserve should be considered."

Substantially the same regulatory provisions interpretative of like statutory provisions in regard to bad debt reserves have been in effect ever since that time. Art. 155 of Regulations 62 (1921 Act), Regulations 65 (1924 Act), and Regulations 69 (1926 Act); Art. 195 of Regulations 74 (1928 Act) and Regulations 77 (1932 Act); Art. 23 (k)–5 of Regulations 86 (1934 Act), Regulations 94 (1936 Act) and Regulations 101 (1938 Act); and, thereafter, Sec. 19.23 (k)–5 of Regulations 103 (Internal Revenue Code). Since the administrative interpretation placed upon the bad debts reserve method has remained the same over a long period of time and Congress by the reenactment of the statutory provision here involved without substantial change has by clear implication ratified that interpretation, it is entitled to great weight and should not be disturbed. *United States* v. *Hermanos y Compania,* 209 U. S. 337, 339; *United States* v. *Safety Car Heating Co.,* 297 U. S. 88.

2d 70 (C. C. A. 8th); *Transatlantic Clock & Watch Co.* v. *Commissioner,* 3 B. T. A. 1064, 1066; *Marks* v. *Commissioner,* 9 B. T. A. 1047.

Moreover, if the petitioner, which used the reserve method, could nevertheless claim a deduction for a specific debt, it could not claim a deduction on account of the indebtedness here involved, for that debt was neither ascertained to be worthless nor charged off during the taxable year.[6]

It is implicit in the statute that the deduction allowed under the reserve method is an addition to the reserve fund made at the end of the year

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[6] The taxpayer's books at the beginning of the year 1934 showed the amount of "the $180,000 loan as notes receivable secured by property at 11th and Hill Street," and that "At the end of the year it showed as real estate, land and building, at 11th and Hill Streets," the transfer having been made from the notes receivable account to the asset account in that amount without any debit to the profit and loss account and credit to the bad debt reserve account or charge-off of the loss on the books. (R. 83–84.) It has been held that a taxpayer's transfer on its books of mortgage debts from one asset account to another does not constitute a statutory charge-off. *Malden Trust Co.* v. *Commissioner,* 110 F. 2d 751 (C. C. A. 1st).

The testimony shows that the taxpayer considered the transaction "as a purchase of the property for the amount of the debt" (R. 71), and that "they got title to the property and we considered it then as being an investment in real estate. They had had other transactions similar to that where they took over the property in partial settlement of accounts" without "reflecting any profit or loss until ultimate liquidation of the property received in exchange." (R. 85–86.)

which is "reasonable" in the light of the facts then known and the regulations make this clear. Article 23 (k)–5 of Regulations 86 requires that a taxpayer using the reserve method attach to his return a statement showing—

> the volume of his charge sales (or other business transactions) for the year and the percentage of the reserve to such amount, the total amount of notes and accounts receivable at the beginning and close of the taxable year, and the amount of the debts which have been ascertained to be wholly or partially worthless and charged against the reserve account during the taxable year.

This information is required in order that the Commissioner may determine whether the addition to the reserve fund is reasonable in amount in the light of the facts, and it seems clear not only that his determination is to be based on the facts submitted, but also that the Commissioner is given wide discretion in determining this issue. Where, as here, the Commissioner has accepted as a reasonable addition to the reserve fund the addition made in a particular year, it is questionable whether the Commissioner's action in refusing a subsequently claimed increase would be open to review, at least in the absence of arbitrary and capricious action. *Consolidated Dry Goods Co.* v. *United States,* 35 F. Supp. 523 (Mass.). See also *Farmville Oil & Fertilizer Co.*

v. *Commissioner*, 78 F. 2d 83 (C. C. A. 4th). But in any event it is clear that additions made at the time cannot be enlarged in the light of subsequent discoveries or events. *Farmville Oil & Fertilizer Co.* v. *Commissioner, supra; Consolidated Dry Goods Co.* v. *United States, supra.*

In the instant case the taxpayer had not determined in 1934 that the property was worth less than the amount of the debt, but on the contrary entered the property on its books at the full amount of the indebtedness and did not until 1938 appraise the property. While its failure to ascertain that there was any discrepancy is explained by its assumption that the debt was exchanged for the property and no part of the indebtedness would be considered as an uncollectible debt, the fact is that it did not know what if any deficiency there was, and would not, therefore, have been justified in increasing its reserve to reflect any deficiency.

The petitioner argues that the court below held that in using the reserve system as in the case of the specific debt system the taxpayers must ascertain the debt to be worthless and charge it off. But the decision does not necessarily go that far. While the court did say (R. 139) that under the reserve system the debt must be ascertained to be worthless and "charged against the reserve," during the taxable year, the rest of the opinion indicates that the court meant that

to justify the reflection of an item in the addition to the reserve there must be an ascertainment in the year that the addition is made that the account is uncollectible or that there is a reasonable probability that it will not be collected (R. 136), and that the addition to the reserve reflecting this fact must be made at that time. We think this is a proper construction of the statute, and in any event that the court was correct in holding that the taxpayer's discovery in 1938 that there was a deficiency did not justify a retroactive increase in the addition to the reserve.

None of the decisions relied upon by the taxpayer (Br. 24–25) is in conflict with the decision below. Whether or not a deduction claimed in a prior year may be changed in a later year on the basis of subsequent discoveries or events depends upon the terms of the provision granting the deduction. None of the cases cited deals with the problem here except *Commissioner* v. *Spreckels,* 120 F. 2d 517 (C. C. A. 9th), which holds merely that a transaction such as the one here involved may give rise to a bad debt deduction, where the taxpayer has charged off the deficiency as uncollectible in the year when the property was accepted in satisfaction of the debt.

The taxpayer contended below, as it does now (Br. 21–27), that since through ignorance of the law controlling the transaction herein it failed timely to ascertain or reflect on its books the

amount of the loss but sought to correct the situation by a claim for refund filed in 1938, it should not be denied the right of deduction merely because of such inadvertence or ignorance of the law. It may be noted that the regulations gave the taxpayer notice that any difference between the value of the property and the indebtedness should be treated as a bad debt. Article 23 (k)–3 of Regulations 86. Ignorance of the law does not warrant a taxpayer's failure timely to ascertain worthlessness and charge off a debt or make a reasonable addition therefor to its bad debt reserve within the taxable year, as required by the statute, regulations and authorities. Section 23 (k), Revenue Act of 1934; Articles 23 (k)–1, 23 (k)–3, and 23 (k)–5, Treasury Regulations 86 (Appendix, *infra*); *Farmville Oil & Fertilizer Co.* v. *Commissioner, supra; Consolidated Dry Goods Co.* v. *United States, supra.* The taxpayer cites no authority to the contrary.

The amendment effected by Section 124 (a) of the Revenue Act of 1942, c. 619, 56 Stat. 798 (26 U. S. C., Supp. IV, Sec. 23), relied upon by the taxpayer (Br. 26), can have no application herein for the taxable year 1934. That statute was made retroactive only to cover taxable years beginning after December 31, 1938. Section 124 (d), Revenue Act of 1942.

Moreover, the taxpayer's reliance on Section

322 (a) of the Internal Revenue Code (26 U. S. C., Sec. 322) (Br. 3) is untenable. That section merely deals with the period of limitations for securing refunds and has no bearing on the question here involved.

CONCLUSION

The petition presents no conflict of decisions and presents no other reason for certiorari. The petition should therefore be denied.

Respectfully submitted.

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